LOANS ON LIFE INSURANCE POLICIES

Loans on life insurance policies is a subject which is receiving the serious attention of life insurance officials and state supervisors of insurance. The granting of loans on policies has had a marked effect already upon the practice of insurance and it threatens to affect the theory of life insurance.

The present situation is due to legislation, to court decisions, and to the practice of some companies. The loan in its present form was devised by some of the enterprising companies primarily as a desirable selling feature of life insurance. Later the legislatures required by law the granting of the loan. The courts by their interpretation of the insurance contract encouraged the practice of granting loans. Early in the history of life insurance, notes were accepted as a partial payment for the premium. This was done in the belief that future dividends would liquidate the debt, and, when later experience proved this belief false, these notes were consolidated into one note which was made as a loan against the reserve on the policy.

However, it was not until about 1885 that the practice of making direct loans against the policy was begun. These loans were not necessarily made for premiums due. They were granted on the theory that each policy holder had a basic right, in insurance theory, in law, and in morals, to use in whatever manner he chose the cash value of his policy, which approximated its reserve value. It assumed that the reserve was divisible at any time into individual reserves, a contention which in strict insurance theory cannot be admitted. It was found that the loan feature in a policy proved an excellent selling device, and the insurance companies willingly or unwillingly adopted it. The Armstrong laws in New York required this feature in all policies sold in that state. Other states, when it was necessary, adopted a similar requirement. Thus, what had originated as a practice of some companies soon became legalized for all companies.

This legislation and company practice were also in harmony with the interpretations which the courts had increasingly placed upon the character of the insurance contract. The decisions of the courts in this country have never been noted as sources of very accurate or fundamental knowledge of insurance and in this particular they have maintained their reputation. From the earliest decisions of the courts in both England and the United States, the insurance contract has been held to be one from which the in-

sured could in no manner profit. The underlying assumption of this principle is that the insurance contract is either one of indemnity, as in the case of property, or one primarily for the benefit of a second party, as in life insurance.

The life insurance contract is in strict theory a trilateral contract with the insurer, the insured, and the beneficiary, as the parties to the contract, the rights or benefits of the contracts being vested in the beneficiary. It is only by recognition of such a principle that the theory of insurance can be made to work in practice, whatever modifications of the real theory may be found in the present-day practice of insurance. Notwithstanding that the early and late court decisions uphold the theory that the insured should not benefit from the contract, another line of decisions has grown up parallel with this which is essentially opposed to it.

That is, the courts have been disposed, especially in later years, to rule that the insurance contract is unilateral. This has been shown not only in interpreting laws requiring a loan to be made upon the policy, but also in permitting a free choice of a beneficiary and a change almost at will of the beneficiary. This is but applying a theory which has come to be more and more adopted by the courts—that insurance is but a species of property. If the contract of insurance thus establishes a property right in the insurance and if this property resides in the insured, he is permitted to do what he pleases with it, just as with any other of his property, so long as no public injury is inflicted thereby. Thus, by classifying insurance in the same category with other kinds of property, the courts have greatly aided in modifying the earlier and more correct idea of what insurance really is.

Therefore, the courts, the legislatures, and the practice of companies have all contributed to encouraging loans on policies and to giving to existing life insurance transactions many of the general characteristics of any modern business.

Insurance as an institution has come to perform many of the functions of banking and saving institutions. It is frequently asserted by the officials of insurance companies, especially when they are seeking exemption from tax laws or modifications of them, that insurance is not a commercial business; that it is not a business for profit. But an examination of the actual activities of a modern life insurance company makes it difficult to admit the contention as a whole.

The loan privilege, just as the development of the so-called in-

vestment policies and many other features of present-day operations, has undoubtedly furthered the sale of policies; but the incorporation of these many attributes has been at a sacrifice, to a greater or less degree, of the fundamental principles of insurance. Insurance is not primarily either a saving or an investment institution. It cannot hope to compete with financial institutions, especially as these institutions become better organized and the people become more intelligent in matters of insurance and investment. Insurance is primarily a means of assuming and distributing risks in order to grant protection. Whatever saving or investment features it may have are but incidental to the main purpose.

Evidence is not wanting that there is a disposition to return to elementary principles. The present interest in the loan clause is a part of this evidence. The increasing interest in state insurance is another. The reorganization of the fraternal companies on a sound basis may prove a means of bringing insurance practice back to fundamental principles. But the laws of many states, the decisions of many courts, and the practice of many companies will need to be revised if life insurance is to return to first principles and perform its primary service of granting protection to third parties. That is, the normal insurance contract should be a trilateral contract with vested rights in the beneficiary.

How extensive loans on policies have become and the relation of policy loans to the reserve is shown by the following table:

Statistics of Companies Reporting to New York Insurance Department.

Year	Sum of policy loans and premium notes	Ratio policy loans and prem. notes to reserve Per cent	Year	Sum of policy loans and premium notes	Ratio policy loans and prem. notes to reserve Per cent
1888	$18,804,810	3.32	1901	$108,438,671	6.85
1889	19,839,332	3.22	1902	127,927,668	7.36
1890	19,903,242	2.97	1903	158,567,609	8.27
1891	21,053,640	2.90	1904	189,738,779	9.03
1892	22,170,066	2.81	1905	225,568,149	9.83
1893	27,669,171	3.24	1906	265,902,863	10.76
1894	30,839,727	3.38	1907	348,458,980	13.15
1895	35,524,530	3.62	1908	413,265,207	14.61
1896	44,833,176	4.28	1909	446,276,468	14.74
1897	51,962,850	4.65	1910	495,099,854	15.34
1898	57,258,660	4.76	1911	541,789,999	15.71
1899	70,836,554	5.35	1912	587,704,733	16.03
1900	88,500,575	6.13			

The following table shows the geographical distribution of loans:[1]

States	Ratio of loans and notes to reserves 1907	1911	Per cent of increase of 1911 ratio over 1907 ratio
Central Northern	11.21	12.89	14.98
Northwestern	11.88	15.22	28.11
New England	12.19	13.50	10.74
Southwestern	13.26	18.29	37.93
Middle Atlantic	13.65	15.67	14.79
South Atlantic	13.89	18.30	31.74
Gulf and Mississippi Valley	14.18	18.55	30.81
Pacific	15.69	19.76	25.93

There are no satisfactory data for determining the purpose for which loans are made, the time the loan remains outstanding, the expense of making the loans, the relation of loans to lapses, and the kind of policy upon which loans are most numerous. Some of these questions cannot be answered, and others will require considerable investigation. The following preliminary result of the study of the experience of one company is offered. It is probable that the more complete analysis of other companies will show very largely the same result, since the following data were obtained from a representative company which has had a long history of excellent business and good administration.

Only the past ten years is included, since this period serves to show the characteristics of the loan.

Year	Number of loans made (a)	Total number of loans outstanding (b)	Per cent of number of loans out to number of policies (c)	Number of loans paid by cash (d)	Per cent of surrendered policies with loans (e)
1904	1099	3995	6.2	241	16.1
1905	1179	4759	6.8	285	16.7
1906	1258	5538	7.4	227	19.2
1907	2121	7058	9.2	407	26.5
1908	2783	9087	11.6	439	27.8
1909	2590	10606	12.7	331	35.4
1910	2693	12259	13.7	286	36.5
1911	2749	13891	14.5	229	39.8
1912	3122	15574	14.9	181	39.3
1913	3806	17751	15.7	47	38.3

[1] *Proceedings of the American Association of Life Insurance Presidents,* 1913.

Attention needs to be given to certain parts of the table. Comparing columns (a) and (b) with column (c) shows that not only an increasing number of loans were demanded annually, but also that those previously made persisted. That is, in the ten-year period the percentage of outstanding loans to the number of policies in force increased from 6.2 per cent to 15.7 per cent. This occurred while the company was annually writing an increasing number of new policies. It will be observed by referring to column (d) that the number of loans paid in cash has been decreasing. In this company, of the total outstanding loans in 1903 there were 5.1 per cent paid in cash in that year. But in 1913 only 2.9 per cent of the outstanding loans were paid in cash. It has been estimated that not 10 per cent of the loans made are ever paid or ever will be paid. It is only by a cash payment that the insurance can be restored intact. Therefore, this fact has great significance because it means that the insurance and therefore the protection is being reduced. The amount of protection thus reduced by loans in December 31, 1912, assuming that only 10 per cent of these will be paid and assuming that the contracts will be carried to maturity, is $503,312,500. Column (e) shows the percentage of all policies surrendered which have had loans on them. The question arising in this connection is, Do loans tend to cause policy holders to give up their insurance? It will be observed that the percentage of policies surrendered with loans on them increased during the decade from 16.1 per cent to 38.3. This fact would seem to be presumptive evidence that loaning on policies has an effect in producing lapses.

The number of loans is, as indicated by the preceding tables, responsive to the industrial conditions. This is true not only because the loans are easy to negotiate but also because in many companies the contracts guarantee that the loan will be granted at a rate of interest which is frequently lower than many policy holders could secure from other loaning institutions during a period of "tight money." The very fact that the loan can be secured by filing a request is an inducement for the policy holder to make the loan which he desires, either because he is hard pressed for ready funds or desires money to take advantage of the low price of securities or the business embarrassments of others.

The objections to the loan privilege are, therefore:

First, it reduces the insurance; that is, the beneficiary's protection is reduced by the amount of the loan. If insurance is

primarily for protection, it logically follows that to the extent the loan defeats protection, it is opposed to insurance.

Second, the loan feature in its operation not only promises serious difficulties in the practical administration of insurance, but it is also opposed to the theory of insurance. By granting the loan privilege the company is forced to keep either in cash or in liquid assets a large amount of its funds. This usually would mean a low interest earning on the funds unless a most extraordinary adjustment of inflow premiums to outflow loans and paid loans could be secured. The only other possible choice which the company has is to be willing to market its long-time securities when a large volume of loans is demanded. Since this large demand is likely to come when industrial considerations are below normal, it means a sacrifice sale of securities. Thus the practical result is likely to be a reduced net interest earning on investments. Since the interest rate and the mortality rate constitute the foundation of the whole superstructure of insurance, the stability of the structure itself may be weakened.

Third, the loan privilege as now practiced denies another fundamental principle of insurance, namely, its mutuality. It assumes that insurance is primarily individualistic; that each one pays a certain sum which does not lose its identity in a general fund for the protection of all the members of the group; that each one may use at any time this personal fund for whatever purpose he pleases. In the reaction against the earlier practice of companies in refusing to give any surrender value when the policy holder failed to pay his due premium, an extreme application has been made of the policy holder's equity in the general fund. The correct reasoning which grants a surrender value is quite different from that which leads to a loan value. A surrender value is given when the individual ceases to continue a member of the group. He withdraws his equity. He takes out from the whole protection that protection which up to that date he has purchased. But in the case of a loan, he practically takes out that protection and still remains a member of the group whose existence is making possible the continued protection for all its members. It is individuality amidst mutuality. Insurance cannot concern itself primarily with individuals. It may, from one point of view, often be individually inequitable, but collectively it is always fair and equitable.

It may be urged that a loan is warranted in the case of an individual whose business is threatened with ruin; and that if such aid

were not extended, the protection which the business gave to the dependent would be destroyed. Such cases, in which a loan would protect a policy holder's business, may occur; but if there is any one thing against which insurance does protect, it is the vicissitudes of modern business.

The one reason most frequently assigned to justify a loan is that it is needed for the payment of a premium due. Yet in such cases it reduces protection and, considering the actual and possible abuses of the loan, it is questionable if the loan granted for this purpose will in the end best serve insurance. The policy contract now provides for extended insurance in case a premium is not paid, and it might be better to compel the policy holder to take the extended insurance. If he is really interested in having that protection which insurance alone can supply, he will pay the premium past due and revive his insurance. If, however, a loan is secured to pay a due premium, sufficient additional insurance should be taken to protect the beneficiary while the loan is in force.

It would be interesting to see the effect upon loans which the foregoing suggestions would have if they were enforced by all the companies. It would also be interesting to see the effect upon loans, if every policy holder were required to secure the consent of the beneficiary before a loan could be secured, especially if every one were compelled to nominate a beneficiary, if he had either any one who was dependent upon him or any one who had an insurable interest in his life.

The foregoing assumes that insurance is not taken primarily for the benefit of the insured, but for a beneficiary. This is the only substantial basis upon which insurance in the truest sense can be justified. It is not forgotten that insurance has been made to serve other purposes, but it is believed that these other purposes are often a distortion of the true insurance principle.

Insurance is often urged as a method of saving, as encouraging thrift, and as an investment. But if a person considers himself alone, there are other more productive means of securing the results of saving. On purely individual grounds, he has little reason to save for a fund available at death, or even for a fund which, by the method of insurance, is to be personally used in late life.

There is no immediate prospect that the above radical suggestions will be adopted. In the meantime, certain protective provisions can be placed around the loan privilege. The consent of the beneficiary, when one is nominated, can be required before a loan

is granted. The companies can include in the loan clause the privilege of a thirty-day or longer time limit in which to grant the loan, similar to that used by savings banks. This would tend to protect the funds during the times of business depression when the demand for loans is great. The companies can also place a higher limit upon the rate of interest at which they agree to make loans.

The loan clause in its present form and practice means a greater and greater commercializing of insurance. Notwithstanding the large use of it already made, its greater use is prevented only by the fact that policy holders do not in general know of its availability. So far, loans have been in most cases possible without serious results because of the steady current of inflowing premiums. If another period of high money rates should occur, and policy holders should have learned of the availability of their insurance funds, the outflowing current might cause a serious loss in securities, not to mention the previously stated fundamental objections to the loan clause, as it is now written.

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